Alberta Heritage Savings Trust Fund

BUSINESS PLAN 2009-12

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The Business Plan was reviewed and approved by Treasury Board on March 4, 2009, and by the Legislature's Standing Committee on the Alberta Heritage Savings Trust Fund on March 16, 2009.

STATUTORY MISSION

To provide prudent stewardship of the savings from Alberta's non-renewable resources by providing the greatest financial returns on those savings for current and future generations of Albertans.

BACKGROUND

The Alberta Heritage Savings Trust Fund (Heritage Fund) was created in 1976 to save a portion of Alberta's non-renewable resource revenue. From inception until 1987, the government set aside part of the province's oil and gas revenue in the Fund. Since 1982 income from the Fund has been transferred to the General Revenue Fund and, to date, over $30 billion has been made available to fund Albertans' priorities such as health care, education and infrastructure.

The Fund is managed as an endowment fund with the goal to maximize long-term returns at a prudent level of risk. The Fund is not to be used for economic development or social investment purposes.

Past public consultations have confirmed the importance of the Heritage Fund as an endowment, underscoring the need to preserve its real value over the long-term. The *Alberta Heritage Savings Trust Fund Act* includes an inflation-proofing provision requiring a portion of Heritage Fund income to be retained to protect its real value. Regular inflation-proofing of the Heritage Fund started in 2005-06 once the province's accumulated debt was eliminated.

The Fund consists of investments in bonds, public and private equities, hedge funds, derivatives, real estate and other real asset investments such as infrastructure and timberlands. The assets of the Heritage Fund are globally diversified with investments in Canada, the United States, Europe, Asia, and the Far East.

Assets and income of the Heritage Fund are fully consolidated with the assets and revenue of the province. All income earned during a fiscal year, except for amounts retained for inflation-proofing, is transferred to the province's General Revenue Fund and is used to help pay for government programs and services.

In 2008-09, the Heritage Fund is forecast to post an investment income loss of $2.41 billion. As a result of the loss, no income is being transferred to the General Revenue Fund. Also there is no income available for inflation proofing of the fund.

FUND GOVERNANCE

The Minister of Finance and Enterprise is responsible for the management and investment of the Fund and is required to report on the performance of the Fund within 60 days of the end of each quarter and make public the annual report within 90 days of the end of the fiscal year. The Minister of Finance and Enterprise prepares the business plan and presents it for approval to Treasury Board and the Standing Committee on the Alberta Heritage Savings Trust Fund.

When investing the assets of the Fund, the *Alberta Heritage Savings Trust Fund Act* requires the Minister to adhere to investment policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return.

The *Alberta Heritage Savings Trust Fund Act* requires there to be a Standing Committee on the Alberta Heritage Savings Trust Fund which has representation from the major parties of the Legislature. The Standing Committee

reviews quarterly reports and approves the business plan and annual report of the Fund. The Committee reviews the performance of the Fund after each fiscal year end and reports to the Legislature whether the mission of the Heritage Fund is being fulfilled. An annual public meeting of the Standing Committee is held in different locations throughout the province. The purpose of these meetings is to update Albertans on the management of the Fund, answer questions and solicit input on its objectives.

The Minister of Finance and Enterprise is responsible for establishing the investment policy for the Fund. The Finance and Enterprise department provides portfolio analysis, research and investment strategy advice to the Minister. Department staff, along with the Alberta Investment Management Corporation (AIMCo) make recommendations to the Minister of Finance and Enterprise with respect to the business plan and investment policy statements of the Fund. From time to time, the Government may establish policy for investments and will provide that advice to AIMCo and the Department. Further, the Minister will ensure that proper performance review and fund management principles are in place.

The investments of the Heritage Fund are managed by AIMCo in accordance with the investment policies set out by the Minister of Finance and Enterprise. Some assets are managed directly by AIMCo personnel, while others are managed by external managers engaged and overseen by AIMCo.

The Auditor General is the auditor of the Heritage Fund.

GOALS, STRATEGIES AND PERFORMANCE MEASURES

GOAL ONE 1 Maximize long-term returns at a prudent level of risk

What it means

Investment income from the Heritage Fund is an important component of the government's *Fiscal Plan*. All Fund income, except for amounts retained for inflation proofing, is transferred to the General Revenue Fund and used to fund Albertans' priorities. Income for this purpose is determined using accounting conventions and is generally defined as interest income, dividend income and recognized capital gains or losses. In order to provide the most benefit to Albertans, the fund must focus on maximizing returns over the long-term. However, the higher the return target, the higher the level of risk in the portfolio needed to obtain the target. Therefore, the Fund must adopt a prudent investment strategy that balances the level of risk with the goal of high portfolio returns.

Strategies

1.1 Through an ongoing review process, ensure the asset mix is best positioned to achieve the goal of maximizing long-term returns at a prudent level of risk. The Heritage Fund's current Investment Policy Statement, established by the Minister of Finance and Enterprise, sets outs the policy asset mix which is shown in the table provided below for information. This policy asset mix calls for globally diversified investments in both public and private equity, fixed income and real assets.

TABLE 1: ASSET ALLOCATION

(percentage)

Asset Classes	Target	Minimum	Maximum	Actual Asset Mix at 12/31/08[1]
Money Market & Fixed Income	**20**	**15**	**45**	**29.2**
Money Market		0	25	1.3
Fixed Income-Universe		10	35	27.9
- Long-Term		0	10	0
Inflation Sensitive & Alternatives	**30**	**15**	**40**	**22.0**
Real Estate[2]		10	20	13.2
Infrastructure[2]		5	15	2.8
Real Return Bonds		0	10	0
Timberlands[2]		0	5	0.6
Hedge Funds		0	10	5.4
Equity[3]	**50**	**35**	**70**	**48.8**
Canadian		0	15	13.5
Global Developed excluding Canada		20	65	30.8
Emerging Markets		0	10	0.4
Frontier Markets		0	5	0
Private Equity[2]		0	10	4.1
Total Assets	**100**	**100**	**100**	**100**

1 Asset mix is shown on fair value basis.
2 Higher allocations to infrastructure, private equity and timberlands will be subject to the availability of attractive opportunities. There is generally a delay in completing allocations to these asset classes as actual dollar draw-downs lag fund commitments.
3 Long/short investing is allowed in some select equity classes. The long-term target weight reflects the net target exposure.

Strategies continued

1.2 Retain investment managers who employ active management strategies with the objective of adding value above the benchmark portfolio without assuming undue risk.

1.3 Develop a framework for measurement and reporting of the risks associated with the investments of the Heritage Fund to ensure risk is being kept within prudent levels.

1.4 Develop risk measures for monitoring the risks in the Heritage Fund.

Performance Measures	Last Actual 2007-08	Target 2007-08[2]	Target 2008-09	Target 2009-10	Target 2010-11	Target 2011-12
Five year Annualized Benchmark return[1 3]	10.24%	6.53%	CPI +4.5%	CPI +4.5%	CPI +4.5%	CPI +4.5%
Five year Annualized Active Management value-added[4 5 6]	0.86%	0.52%	0.57%	0.67%	0.77%	0.87%
One year Active Management value-added	-0.60%	0.60%	0.75%	1.00%	1.00%	1.00%

1 The Benchmark return target has been set as the Canadian Consumer Price Index (CPI) + 4.5 per cent.
2 The 5 year annualized Consumer Price Index measure is 2.03 per cent.
3 Benchmark return is used to determine whether the asset mix as set out in the investment policy statement is achieving expected returns prior to any value-dded by active investment management.
4 All returns are net of fees unless otherwise noted.
5 Active management returns is used to measure the impact of active fund management on investment performance. It is calculated as the difference between actual investment returns and the Benchmark return.
6 The five year annualized active management return will grow over time as it moves to the 1 per cent active management goal. Current year lower active management will be replaced overtime by the new higher goals.

RISKS TO ACHIEVING GOALS AND PERFORMANCE MEASURES

If the Fund's income is less than expected, the government fiscal plan may be affected. The return on risk-free assets such as Government of Canada bonds alone will not provide expected long-term returns. Assets that have some measure of volatility in their returns must be included in the portfolio in order for the Fund to meet its objectives. Therefore, investment returns and income will vary significantly from year to year and may underperform investment expectations for extended periods of time for the following reasons:

- Diversification among various asset classes lowers but does not eliminate the risk of loss.
- Equities have historically provided investors with higher total returns (dividends and capital gains) than fixed income investments. However, equity returns have significantly higher volatility and dividend yields in general are lower than interest rates, so an equity portfolio will provide lower current income. There have been extended periods of negative returns from equities in the past.
- A well implemented private equity portfolio can provide investment returns above those of public equities. However, by their nature, private equity investments are riskier than public equity investments and are associated with an investment horizon of five to ten years to realize investment gains. Private equity investments are subject to risks such as illiquidity and potentially large or total investment loss.
- Infrastructure investments, bridge loans, and other corporate financing arrangements, provide current income, diversification and an inflation hedge. However, these types of investments are subject to a number of risks, including illiquidity, loss of principal and reduced income.
- Absolute returns strategies (hedge funds) have gained prominence in recent years with an expectation of stable returns. However, this market is very fragmented with investment fees above those of traditional managers. In some cases there have been large losses sustained in the industry by otherwise well informed and highly professional investors. Manager selection and oversight are therefore critical to successful implementation.

GOAL TWO 2 Ensure the Heritage Fund aligns with the fiscal goals of the province.

What it means

The Heritage Fund is the largest single financial asset on the province's balance sheet and an important source of revenue. In order to ensure the fund aligns with the goals of the province it is important to consider how the risks and return profile of the fund interacts within the overall fiscal landscape of the province.

Strategies

- Review the effects of currency fluctuations on the Heritage Fund and how these fluctuations interact within, and impact, the broad fiscal landscape of the province. Determine whether a currency strategy should be applied to the Heritage Fund.

GOAL THREE 3 Ensure the transparency of the Heritage Fund's objectives and results for Albertans

What it means

Published reports and news releases will provide Albertans with access to information to enhance understanding of the Heritage Fund.

Strategies

- Release reports, including quarterly and annual reports, of the Heritage Fund's investment activities and results for Albertans on a timely basis in simple, understandable language.
- The Legislature's Standing Committee holds annual public meetings around Alberta to report on the Heritage Fund's results and to answer questions on the Fund's performance.
- Creation of a comprehensive report for the citizens of Alberta outlining the details and dealings of the Heritage Fund. The report will be created in a format that the average Albertan can identify with.
- Continue to improve the access and depth of information available to Albertan's.

Performance Measures

- Timeliness of reports and public accountability meetings.
- Annual report will be released by June 30 of each year.
- Quarterly reports will be released within two months after the end of the quarter.

INCOME AND EXPENSES

TABLE 2: Heritage Fund Income Forecast

Forecast Annual Income ($millions)	Actual 2007-08	2008-09	2009-10	2010-11	2011-12
Unconsolidated investment income	882	(2,412)	778	879	958
Amounts retained for inflation-proofing	466	-	-	237	312
Transfer to General Revenue Fund	(358)	-	(711)	(572)	(573)
Transfer to Heritage Fund from unanticipated surplus	918	-			
Forecast fair value of the Fund ($billions)	17.0	14.0	14.4	14.8	15.3

The Heritage Fund income forecast is supported by the expected return assumptions shown in Appendix A.

- The income forecasts include interest income, dividend income and realized capital gains or losses.
- Capital gains and losses on traditional investments are not recognized as income until the investment is sold or, given a significant loss that is expected to be permanent, is written down. Therefore, gains and losses that are included in reported market value rates of return may not be immediately reflected in income reported in the financial statements. (In the case of equity index swaps and futures contracts, gains and losses are realized in income as they occur.)
- The Heritage Fund records investments at cost, which exclude unrealized gains and losses. The fair value of investments is provided for information purposes. The Canadian Institute of Chartered Accountants public sector accounting standards regarding the accounting and reporting of financial instruments at fair value for governments are currently under review.
- Actual income and fair value results will vary from projections based on the extent to which actual market returns and interest rates vary from the assumptions used.

RISKS TO THE INVESTMENT INCOME FORECAST

- Fund income is dependant on both cash income (e.g. from dividends and interest) and realized capital gains (losses). Although cash income is relatively stable, capital gains are uncertain and subject to large variance.
- If equity returns are lower than assumed, investment income could be lower because stocks in the Fund could be sold for smaller gains than anticipated, or possibly for losses, depending on the extent of turnover in the various equity portfolios.
- If interest rates go up, the market price of bonds held by the Fund would typically decline. Sales of these bonds would produce smaller gains than expected, or, perhaps, losses, depending on the amount and timing of turnover in the portfolio.
- There are other risks in the portfolio including exchange rate movements and commodity price changes. The Fund has investments in foreign assets such as U.S. equities which are not hedged into Canadian dollars. If the Canadian dollar were to appreciate then this would detract from return. However, the Fund's investments in absolute return strategies, timberlands, infrastructure and foreign private real estate are hedged to the extent practical.

TABLE 3: Heritage Fund Investment Expense Forecast[1]

Forecast Annual Investment Expenses ($millions)	Actual 2007-08	2008-09	2009-10	2010-11	2011-12
Total Annual Expenses	58.8	71.7	67.4	70.4	72.9
As a percentage of fair value	0.35%	0.46%	0.47%	0.48%	0.48%

1 Due to factors such as differences in assumed and actual experience in asset class allocations and growth in the size of the Heritage Fund, actual expenses may differ from forecast expenses. Forecasted expenses do not include external manager performance fees. The forecast reflects a change in methodology as compared to prior years' business plans. Salaries for internal staff previously allocated to direct management costs have been reclassified to the appropriate pools. Most notably, expenses in certain alternative asset classes have been forecasted based on committed capital. Commencing in 2008-09, a new cost system has been used to report Heritage Fund expenses.

- The Fund has recently increased its target allocation to such asset classes as Infrastructure and Private Equity and expects further increases in the future. These products are generally more expensive to run than traditional public equities and bonds. Therefore fees in both absolute terms and as a percentage of fair value are expected to rise. The increase to expected returns is expected to more than offset the increase in fees.

APPENDIX A

Return and Asset Mix Assumptions

Long-Term Capital Market Rate of Return Expectations	
Canadian Money Market	3.75%
Canadian Public Fixed Income	5.00%
Canadian Public Equities	8.00%
Foreign Public Equities	8.00%
Real estate	8.00%
Private Equity	11.00%
Infrastucture	9.00%
Timberland	8.00%
Absolute return strategies	6.75%
Value-added by Active Management (total fund)	1.00%

Budget Assumptions	2008-09	2009-10	2010-11	2011-12
10-year bond rate	3.40%	3.05%	3.65%	4.75%
C$/US$ exchange rate	1.117	1.198	1.143	1.111

APPENDIX B:

Definitions of terms used in the Business Plan

Active Management
Managing the investments of a portfolio with the objective of outperforming the return of its benchmark. Active management generally takes two forms – security selection or asset allocation decisions. Security selection is the buying and selling of particular securities to earn a return above a market index. Asset allocation refers to changing asset class or sector weights to earn a return above what would be available from maintaining the asset class or sector weight in the benchmark.

Asset Allocation
The investment process by which the investment manager chooses or allocates funds among broad asset classes such as stocks and bonds.

Asset (or Investment) Class
Refers to a broad category of investments with similar characteristics (the typical asset classes are cash, stocks, bonds and real estate).

Benchmark
A standard against which performance is measured. Common benchmarks used in investment management are the DEX Universe Bond Index for Canadian fixed income, the S&P/TSX Composite Index for Canadian public equities, the S&P 1500 Index for U.S. public equities, among others.

Bond
A bond is a financial instrument representing a debt where the issuer (corporation or government) promises to pay to the holder a specific rate of interest over the life of the bond. On the bond's maturity date, the principal is repaid in full to the holder.

Capital Gain (or Capital Loss)
The market value received on the sale of an asset, which is higher (lower) than its purchase price (also called cost or book value). If an asset is bought for $50 and sold for $75, the realized capital gain or profit is $25.

Diversification
Diversification is a process of allocation of investment assets within an Asset Class and among asset classes. Diversification is intended to reduce risk.

Dividends
Earnings distributed to shareholders of a company, proportionate to their ownership interest.

Emerging Markets
The term emerging markets is used to describe a nation's social or business activity in the process of rapid growth and industrialization. Currently, there are approximately 28 emerging markets in the world.

Equities
Equities are synonymously called stocks or shares and represent an ownership interest in a company (could be either a public or private firm). Shareholders normally have voting rights and may receive dividends based on their proportionate ownership.

Fixed Income Securities
An investment that is required to pay a fixed interest rate at periodic intervals such as bonds, mortgages and debentures.

Frontier Markets
The term frontier markets is commonly used to describe the equity markets of the smaller and less accessible, but still "investable", countries of the developing world. The frontier, or pre-emerging equity markets are typically pursued by investors seeking high, long-run return potential as well as low correlations with other markets. The implication of a country being labeled as frontier, or pre-emerging, is that the market will begin to develop similar levels of liquidity and exhibit similar risk and return characteristics to that of the more traditional emerging markets.

Global Developed Markets

The term developed markets is used to describe nations whose economies and capital markets are well-established and mature.

Hedge Funds
Absolute return strategies encompass a wide variety of investments with the objective of realizing positive returns regardless of the overall market direction. Investments in absolute return strategies are made through multi-hedge fund-of-funds and direct investments to increase strategy diversification.

Inflation
Increases in the general price level of goods and services. Inflation is one of the major risks to investors over the long-term as savings may actually buy less in the future.

Infrastructure
A private investment that is structured to provide high current income. Examples of investment opportunities include infrastructure projects, bridge loans and corporate finance arrangements.

Investment Grade
An investment grade bond is rated a minimum of BBB (or equivalent) by a rating agency, with AAA being the highest grade. Bonds rated below BBB are generally classified as being speculative grade and carry higher levels of credit risk than investment grade bonds (i.e., they have a higher probability of default on interest or principal payments).

Liquidity
The ease with which an investor can buy or sell an investment at a fair market price.

Money Market Instruments
Debt instruments such as Treasury Bills or corporate paper with a maturity of less than one year.

Nominal Rate of Return
A measure of the earnings performance of a fund measured in current dollars.

Overlay
A portfolio construction technique where the return and risk of an overlay strategy are added to another portfolio's returns without needing to transact in the underlying investments. To achieve this, the overlay strategy is usually executed with derivative securities on an unfunded basis, where notional exposure exceeds the invested capital. The overlay strategy modifies the risk exposure of the underlying investments

Portfolio
A collection of investments owned by an investor.

Private Equity
An equity investment in a private (not publicly traded) company.

Real Rate of Return
The nominal rate of return minus the rate of inflation.

Realized/Unrealized
Terms generally used to describe capital gains or losses. A gain or loss is generally realized when an asset is sold; prior to sale the gain or loss is unrealized and it is only a potential or "paper" gain or loss.

Swaps
Financial agreements whereby counterparties agree to exchange the returns they earn on their respective assets. For example, an investor might swap the return from his bond portfolio for the returns of another investor's stocks and vice versa.

Timberland
Refers to investment in privately owned areas of woodland; that is, forested areas consisting of both hardwood and softwood species. When responsibly managed, timberland investments are a renewable and sustainable resource that responds to demand for lumber and paper products, and provides benefits such as diversification, an inflation hedge, and relatively high yield within the context of a portfolio.